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SUBJECT: AMBASSADOR'S MEETINGS WITH FINANCE AND ECONOMY
MINISTERS

1. (Sbu) Summary: In December 17 meetings with Economy Minister Babacan and Finance Minister Unakitan, the Ambassador stressed the need for continued fiscal discipline, structural reform and resolution of foreign investment disputes. Both Ministers reconfirmed the GOT's commitment to continue economic reform. On privatization, Unakitan seemed committed but overly focused on price whereas Babacan admitted GOT mistakes. Unakitan insisted the GOT would not relent on fiscal discipline despite the upcoming municipal elections. On investment issues, both Ministers accepted the need to resolve some U.S. company disputes and promised renewed effort. Unakitan said the Prime Minister had given instructions to solve the data exclusivity problem. Babacan's comments on the U.S. Financial Agreement will be reported septel. End Summary.

2. (Sbu) On December 17, the day before the IMF Board is scheduled to consider Turkey's Sixth Review, the Ambassador met separately, at his request, with State Minister for Economy Ali Babacan and Finance Minister Kemal Unakitan. Ambassador congratulated the Ministers on the GOT's success in hitting 2003 macroeconomic targets, but also highlighted two major economic challenges: not succumbing to the inevitable populist pressures to spend (or commit to spend) before local elections; and ambitiously implementing the full range of structural reforms, including privatization.

Fiscal Discipline, Minimum Wage Increase:

3. (Sbu) The Ambassador said that one challenge the GOT faced was to avoid the temptation to spend in the run-up to the March municipal elections. One example of this danger was government consideration of a large increase in the minimum wage. Note: the press has reported--and GOT officials have confirmed privately--that the GOT is considering a minimum wage increase of as much as 55 percent. Private analysts immediately pointed out that this could have damaging effects on the fiscal situation, inflationary expectations, and wage competitiveness. End Note.

4. (Sbu) Minister Unakitan confirmed that he was working with the Labor and Economy Ministers and the State Planning Organization (SPO) to come up with a menu of options and their associated costs to present to the Prime Minister. Unakitan claimed that the minimum wage increase would not present problems from a fiscal perspective, since it could increase private sector income tax revenues and receipts of social security premia, and could even be a net fiscal plus to the State. Instead, Unakitan said the concern was the impact on inflation and on exporters' costs, and seemed to imply that these concerns outweighed the advantages of a large increase. In a separate meeting the day before, SPO Undersecretary Ahmed Tiktik told econoffs that he had advised against a large increase.

5. (Sbu) On the broader issue of maintaining fiscal discipline despite the elections, Unakitan insisted the GOT would not sacrifice its hard-earned credibility, saying "we will not do populism." Unakitan said they would not win elections through more spending but by maintaining budget discipline, and said the Prime Minister shares this view. Unakitan characterized fiscal discipline, along with transparency and honesty, as key components of good governance. He personally was willing to be the bad guy and say no to spending, citing some USD 30 million in funds to municipalities that he does not intend to let them spend.

Privatization:

16. (Sbu) On the structural side, Babacan said the government had made progress, but he acknowledged there had been delays as well. He stressed the government's commitment to reform, but added that some changes -- such as privatizations -- depend on outside (market) forces as well. Ambassador interjected that, because no one could predict market developments, the GOT needed to focus less on the price the markets offered for a particular privatization and instead emphasize the efficiency gains from the sales. He added that the bids on Tekel -- lower than the GOT had hoped -- reflected in part the discount investors demanded because of Turkey's poor environment for foreign investment. The Ambassador also worried about some of the groups bidding on privatizations.

17. (Sbu) Babacan agreed that the GOT had made a mistake in raising expectations, adding that he had advised other Ministers (read Finance Minister Unakitan) not even to whisper about price expectations ahead of the next privatization. He added that Privatization Administration President Metin Kilci had told him that, legally, he could not accept a bid below the lower range of valuation estimates private sector advisors had developed for Tekel. More broadly, he acknowledged that the major obstacles to privatization were price and lay-offs, to which Ambassador replied that privatization would only lead to efficiency gains if they produced lay-offs.

18. (Sbu) Babacan argued that the political will to privatize had never been stronger, or at least not in recent memory. He noted that the GOT had reduced the number of workers at state-owned enterprises by 55,000 in 2003 (41,000 of the 45,000 specified in the IMF plan, plus an additional 14,000 from SEEs that exceeded their company-specific targets in the plan).

19. (Sbu) Whereas Minister Babacan seemed to understand the problem of being overly wed to internal valuations of companies to be privatized, Unakitan seemed very much focused on the price to be had, and on not selling state companies too cheaply. He stressed his private sector background and his belief in privatization, and said the Prime Minister also supports privatization. Saying privatization is a multi-faceted issue with labor, regulatory, competition and pricing dimensions, he vowed not to deviate from the path of privatization. He said the Privatization Authority staff was relatively inexperienced and would be more effective in 2004.

10. (Sbu) When disposing of state assets, however, Unakitan said he tries to sell them at the highest possible price. He cited the case of a fertilizer company in Istanbul that was going to be sold for USD 36 million until Unakitan, after consulting advisors, changed tack and eventually sold it for USD 105 million. With Tekel's tobacco operations, Unakitan said they could not sell it for the bid price because it was too far below the valuation provided by the GOT's advisors at Citigroup. Unakitan said that the Tupras privatization would be finalized in January after an environmental assessment but that Petkim was difficult to privatize because of the economic situation.

Improving Market Confidence:

11. (Sbu) Babacan pointed to the August 1 Fund decision to allow Turkey to "restructure" repayments, as well as a successful post-roadshow international bond issuance, as turning points in terms of market confidence. The government will meet or exceed year-end inflation and growth targets (which SPO U/S Tiktik also told us December 16), and expectations for year-end 2004 inflation are within range of the government's 12 percent target. Interest rates have fallen faster than expected (and already are at 2004's projected average, per IMF ResRep), enabling the government to save TL 7-8 quadrillion (\$5-5.5 billion) in interest payments this year. The government's interest rate projections for 2004 are "very conservative," as the government believes it is critical to meet its targets to establish credibility.

12. (Sbu) Babacan stressed that the government was trying to be as consistent and predictable as possible, so as to boost investor and consumer confidence. The success of this effort, combined with the fact that the Prime Minister clearly has supported the economic program in the last half

of 2003, has had a positive impact on confidence.

Investment Disputes:

13. (Sbu) With both Ministers, Ambassador reported that the two governments had discussed foreign direct investment extensively at the recent Economic Partnership Commission meeting, and the GOT delegation had made an effective presentation on recent efforts to improve the investment environment. However, attracting more U.S. investment required not only macroeconomic stability and a streamlined bureaucratic process, but also a good track record among existing investors. Unfortunately, Turkey's track record vis--vis U.S. investors is not good. With Babacan, he cited as examples Cargill's zoning problems (and noted that Cargill's plant here is its largest greenfield investment in the world) and the lack of data exclusivity for pharmaceutical companies. The Ambassador handed both Ministers a non-paper laying out U.S. companies' problems doing business in Turkey.

14. (Sbu) With both ministers, Ambassador suggested that the Prime Minister's late January visit to Washington and President Bush's late June visit to Turkey (for the NATO Summit) were great opportunities for Turkey to highlight its improved investment environment, and urged the government to resolve at least some of the investment problems/disputes before these events. Turkey, he argued, needs some investment success stories.

15. (Sbu) Babacan said he fully agreed. The GOT's Coordinating Committee to Enhance the Investment Environment, which he chairs, had recently invited a number of foreign investors -- including Cargill and Pfizer -- to present their problems. Subsequently, the Prime Minister (with Babacan) had met with the Foreign Investors Association (Yased), and the Prime Minister had taken detailed notes throughout a two hour Yased description of problems facing foreign investors.

16. (Sbu) Babacan said awareness of the problem was the first step. Now, the GOT wants to resolve as many of these problems as possible and make Turkey investor-friendly. If it fails, Turkey will not attain its growth targets. He argued that the biggest problem facing investment is Turkey's judiciary. The courts take too long to make decisions, he said, and those decisions are completely unpredictable -- "like flipping a coin." Judicial reform, he concluded, is essential. (Comment: Interestingly, State Planning U/S Ahmet Tiktik made the same argument to us December 16, calling for an "overhaul" of the judicial system. End Comment.)

17. (Sbu) Unakitan, who had to cut short the meeting, asked the Ambassador to set up another meeting, at which they would go over each U.S. company problem in greater detail. Unakitan promised to try to help, even if the dispute was outside Unakitan's portfolio.

18. (Sbu) With Babacan, the Ambassador pressed for progress on data exclusivity for pharmaceutical companies. He pointed out that the lack of IPR protection not only is a trade problem, in terms of our Special 301 process, but also is a disincentive to investment and could lead foreign pharmaceutical companies to stop bringing new products to Turkey. He warned that, without progress, the U.S. was likely to place Turkey on its Special 301 Priority Watchlist next year.

19. (Sbu) Babacan said he was aware of the problem, had discussed it with the Prime Minister, and intended to talk with the Health Ministry to find a resolution. He said the Health Ministry feared the cost implications of implementing data exclusivity, but he (Babacan) was confident the pharmaceutical companies would work with the Ministry to minimize those costs. Unakitan said the Prime Minister had instructed him to work on the data exclusivity issue and solve it despite the cost to Turkey.